

New Division 7A changes – TR 2010/3 released

On 2 June 2010 the Australian Tax Office (ATO) released Taxation Ruling TR 2010/3 'Income Tax: Division 7A loans: trust entitlements'. The ruling is substantially the same as the drafting ruling, TR 2009/D8, which was released on 16 December 2009. The ATO also released Practise Statement PS LA 3362 on 2 June 2010. The Practice Statement provides some guidance regarding the practical application of the Ruling.

The Ruling outlines when an unpaid trust distribution owing to a corporate beneficiary will be treated as a loan for the purposes of Division 7A. The ruling represents a significant change of ATO policy, and will have significant implications for a large number of family groups.

Note: The term unpaid trust distribution will be described as a UPE (an acronym for unpaid present entitlement) in this fact sheet, for ease of reference.

Scope of the ruling

TR 2010/3 will apply where:

- a trust has an UPE owing to a corporate beneficiary;
- the trust and the corporate beneficiary are part of the same family group (i.e. the same person or persons controls both entities) and;
- the funds representing the UPE are intermingled with other funds of the trust.

Existing UPEs (UPEs that arose prior to 16 December 2009)

The ATO is of the view that certain UPEs owing by the trustee of a trust to a private company beneficiary are loans made by the company beneficiary to the trust within the ordinary meaning of the term loan. The ATO will treat such UPEs as loans retrospectively, although the ATO has indicated in the ruling that the four year amendment period will apply to such loans. Hence any UPE that is treated as a loan retrospectively but which arose prior to four years (the period that the Commissioner is empowered to amend assessments) may not give rise to a deemed dividend.

The ATO will consider that an UPE distribution is an ordinary loan in circumstances where there has been an agreement between the trust and the private company. Such an agreement may be expressed or implied (i.e. inferred by the actions of the parties).

Generally the accounting treatment of the UPE will be the main evidence of the parties' actions. If the trust deed gives the trustee power to act on behalf of the beneficiary, and the trustee has credited a loan account to the private company, the UPE will be treated as a loan. This will be the case regardless of how the UPE is recorded in the company's accounts.

If there is no such power in the trust deed, the ATO will only treat the UPE as a loan if the trust credited a loan account reflective of the amount owed to the private company and the private company has debited a loan account owing to the trust.

We note that the accounting treatment will not be determinative and hence in situations where there is sufficient evidence to the contrary, the UPE may not be treated as a loan regardless of the accounting treatment.



If existing UPEs are considered loans, the amount of the UPE will be treated as an assessable unfranked dividend in the income year in which the UPE arose. Hence, as a result of this ruling, you may be required to amend prior year income tax returns.

Depending on the circumstances, it may be possible to apply to the Commissioner to exercise his discretion under section 109RB to disregard the deemed dividend. The Commissioner will only grant this request if he is satisfied that the deemed dividend arose as a result of an honest mistake or an inadvertent omission.

However, where an existing UPE created before 16 December 2009 is not considered a loan, the ruling will not apply to that UPE. Therefore, all pre 16 December 2009 UPEs will need to be quarantined in the accounts of the trust and company.

UPEs going forward

Going forward from 16 December 2009 the ATO will consider that many UPEs owing to private company beneficiaries that are not regarded as actual loans under the ordinary meaning of the term loan will be deemed by the ATO to be loans for Division 7A purposes.

This is because the ATO considers that the majority of UPEs will fall within the extended definition of a loan for Division 7A purposes; being a financial accommodation or an "in substance" loan. The one important exception to this is where the funds represented by the UPE are held on sub trust for the sole benefit of the company beneficiary (discussed further below).

The ATO have acknowledged that this is a change in view. This is the rationale for this view being applied only prospectively from the date of the draft ruling.

If post 16 December UPEs owing to private company beneficiaries are considered loans for Division 7A purposes (under the extended definition of the term loan), the ATO's view is that the conversion from UPE to loan occurs during the year following the year in which the UPE first arises.

Therefore, where a new UPE that arises in an income year is outstanding at the end of the following income year, the taxpayer has three options:

- a. to pay out the UPE before the lodgement day of the trust's tax return for the following income year
- b. to enter into a Division 7A loan agreement before the lodgement day of the trust's tax return for the following income year. A Division 7A loan agreement will require the UPE to be paid out progressively with minimum annual repayments over seven years (unless secured against real property in which case it may be 25 years) and be subject to a benchmark rate of interest or
- c. ensure funds representing the UPE are held on sub trust for the company's sole and absolute benefit. This exception is outlined in more detail in the Tax Office's draft Law Administration Practice Statement PS LA 3362 and discussed in further detail below. We note that there is still significant uncertainty regarding the sub trust concept.



According to the Draft PS LA 3362, the following requirements must be met in order to satisfy the ATO that a sub trust is in existence:

- The trust deed must permit a sub trust arrangement;
- The accounting treatment of the UPE must reflect the fact that the funds are being held on sub trust.
- The terms of the investment of the sub trust funds into the main trust must be documented. The documentation must be sufficient to create an obligation on the trustee to pay the return on investment to the sub trust.
- There must be an appropriate return paid on the investment.

The ATO has outlined two options for calculating the return on investment which are summarised as follows:

1. **Option 1:** Option 1 involves paying out the UPE to the company beneficiary within seven years of the date of investment being made with an annual interest charge being paid, this charge being calculated using the benchmark rate. This may be more favourable than entering into an ordinary Division 7A loan agreement, as the loan can be paid back on the last day of the seven years, rather than making minimum yearly repayments every year.
2. **Option 2:** Option 2 involves paying out a percentage of the trust net income to the company beneficiary each year. This percentage is calculated by reference to the portion of the total gross assets in the main trust represented by the funds invested by the sub trust. Under Option 2, no return is required if the trust is in a loss position. Furthermore, a repayment of the UPE is not required within a specified time limit.

We appreciate that the above is technically complex. If you have any further queries or would like more information on other amendments, please do not hesitate to contact us on 02 4928 8500.

